No. 95-1847

(3)

Supreme Court, U.S.
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In The

Supreme Court of the United States

October Term, 1995

THE SANTA CRUZ OPERATION, INC., a California corporation, LARS H. TURNDAL, DAN E. STEIMLE, DOUGLAS L. MICHELS, and LAWRENCE MICHELS,

Petitioners,

v.

DR. STEPHEN MOSKOWITZ, LENORA ISAACS, JERRY KATZ, IRA ROLLOVER, and DAVID ACKERMAN, on behalf of themselves and all others similarly situated,

Respondents.

Petition For A Writ Of Certiorari To The Court Of Appeal Of California Sixth Appellate District

BRIEF FOR RESPONDENTS IN OPPOSITION

RICHARD B. DANNENBERG
Counsel of Record
RICHARD BEMPORAD
JODY KRISILOFF
LOWEY DANNENBERG BEMPORAD & SELINGER, P.C.
747 Third Avenue
New York, NY 10017
(212) 759-1504

Attorneys for Respondents

Of Counsel:
LIEFF, CABRASER, HEIMANN & BERNSTEIN
JAMES M. FINBERG
Embarcadero Center West
275 Battery Street, 30th Fl.
San Francisco, CA 94111
(415) 956-1000

June 10, 1996

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QUESTION PRESENTED

Did the California Court of Appeal's unpublished opinion properly sustain plaintiffs' complaint for violation of Sections 11, 12(2) and 15 of the Securities Act of 1933 (the "Securities Act"), where the complaint details numerous statements in a registration statement and prospectus for a $75,000,000 initial public offering concerning the central roles played and to be played in the Company's operations and management by the Chairman of the Board that were rendered highly misleading by defendants' failure to disclose that, as personally known by defendants prior to the offering, the Chairman was terminally ill and had been told to get his personal affairs in order, and was curtailing his involvement in the Company's business activities?

TABLE OF CONTENTS

Page

QUESTION PRESENTED i

STATEMENT OF THE CASE 1

A. Factual Background 1

B. Procedural History 6

C. Proceedings In The California Appellate Courts 7

REASONS FOR DENYING THE WRIT 8

I. NOTHING MANDATES THIS COURT'S REVIEW 9

II. A. THE CALIFORNIA COURT OF APPEAL'S DECISION IS CONSISTENT WITH THE FEDERAL SECURITIES LAWS 11

B. TECHNICAL COMPLIANCE WITH THE SEC'S MINIMUM DISCLOSURE REQUIREMENTS DOES NOT INSULATE PETITIONERS FROM LIABILITY FOR THE DISSEMINATION OF A MISLEADING PROSPECTUS 14

C. THE COURT OF APPEAL PROPERLY DETERMINED THAT HARRIS' TERMINAL ILLNESS COULD BE MATERIAL TO A REASONABLE INVESTOR 17

III. THE COURT OF APPEAL'S RULING DOES NOT CONFLICT WITH THE AMERICANS WITH DISABILITIES ACT 20

CONCLUSION 26

TABLE OF AUTHORITIES

Page(s)

CASES

Basic Inc. v. Levinson, 485 U.S. 224 (1988)..... 8, 17, 22

Breard v. Sachnoff & Weaver, Ltd., 941 F.2d 142 (2d Cir. 1991) 19

Central Bank v. First Interstate Bank, 114 S. Ct. 1439 (1994) 13

Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976)...13, 18

Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544 (E.D.N.Y. 1971)..... 16

Gould v. Tricon, Inc., 272 F. Supp. 385 (S.D.N.Y. 1967)..... 19

Hines v. Data Line Systems, Inc., 53 Wash. App. 283, 766 P.2d 1109 (Wash. Ct. App. 1989), *aff'd*, 114 Wash. 2d 127, 787 P.2d 8 (Wash. 1990).....17, 18

In re Bank of Boston Corp. Sec. Litig., 762 F. Supp. 1525 (D. Mass. 1991) 14

In re Laser Nucleonics, Inc., 44 S.E.C. 206, 1970 SEC LEXIS 672 (1970) 20

In re Numerex Corp. Sec. Litig., 913 F. Supp. 391 (E.D. Pa. 1996) 19

In re Quarterdeck Office Sys., Inc. Sec. Litig., [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶97,646 (C.D. Cal. Nov. 4, 1992) 19

In re Sweet's Steel Co., 4 S.E.C. 589, 1939 SEC LEXIS 547 (1939)..... 20

Kas v. Financial General Bankshares, Inc., 105 F.R.D. 453 (D.D.C. 1984)..... 17

TABLE OF AUTHORITIES – Continued

Page(s)

Kass v. Arden-Mayfair, Inc., 431 F. Supp. 1037 (C.D. Cal. 1977) 20

Lewis v. United States, 445 U.S. 55 (1980) 13

Maldonado v. Flynn, 597 F.2d 789 (2d Cir. 1979) 16

SEC v. Century Mortgage Co., 470 F. Supp. 300 (D. Utah 1978) 20

SEC v. Electronics Warehouse, Inc., 689 F. Supp. 53 (D. Conn. 1988), *aff'd*, 891 F.2d 457 (2d Cir. 1989), *cert. denied*, 110 S. Ct. 3228 (1990) 19

SEC v. Falstaff Brewing Corp., 629 F.2d 62 (D.C. Cir. 1980), *cert. denied sub nom. Kalmanowitz v. SEC*, 449 U.S. 1012 (1980) 13

SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969) 24

Shaw v. Digital Equip. Corp., 1996 U.S. App. LEXIS 10461 (1st Cir. May 7, 1996) 24

TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976) 17

Zell v. InterCapital Income Securities, Inc., 675 F.2d 1041 (9th Cir. 1982) 16, 20

STATUTES

15 U.S.C. § 77k 6, 11, 12

15 U.S.C. § 77l 6, 11

15 U.S.C. § 77o 6

42 U.S.C. § 12101 *et seq* 21

29 C.F.R. 1630.15(e) (1994) 24

TABLE OF AUTHORITIES – Continued

Page(s)

SEC RELEASES

In re Registration Statement of Cytotech Corp., SEC Release No. 33-6800, 1988 SEC LEXIS 1905 (September 29, 1988) 18

In re Franchard Corp., Securities Act Release No. 4710, [1964-1966 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶77,113 (July 31, 1964) 15

MISCELLANEOUS

H.R. Rep. No. 152, 73d Cong., 1st Sess. 26 (1933) 12

Susan Antilla, *Death and The Company; Should Shareholders Know The State of CEO's Health?*, International Herald Tribune, June 27, 1994 23

Andrew K. Glenn, *Disclosure of Executive Illnesses Under Federal Securities Law and the Americans With Disabilities Act of 1990: Hobson's Choice or Business Necessity?*, 16 Cardozo L. Rev. 537 (1994) 23, 24

5B Jacobs, *Litigation and Practice Under Rule 10b-5* § 61-01[c][i] (1991) 16

Rob Seitz, *Corporate Conundrum: Disclosing Illness in the Corner Office*, N.Y. Times, May 2, 1993 23

Respondents Dr. Stephen Moskowitz, Lenora Isaacs, Jerry Katz, IRA Rollover and David Ackerman (collectively, the "Respondents"), respectfully request that this Court deny the Petition for a Writ of Certiorari to the Court of Appeal of California, Sixth Appellate District (the "Petition") submitted by The Santa Cruz Operation, Inc. ("SCO" or the "Company") and the four individual Petitioners (collectively, the "Petitioners"), to review an unpublished opinion of the California Court of Appeal reversing a demurrer by the California Superior Court and sustaining Respondents' Second Amended and Consolidated Complaint (the "Complaint").[1] This case presents *none* of the "special and important reasons" for review enumerated in Rule 10 of this Court's Rules.

STATEMENT OF THE CASE

A. Factual Background

SCO is a California corporation which provides software for computer systems. Pursuant to a Registration Statement and Prospectus dated May 26, 1993 (collectively, the "Prospectus"), Petitioners effected an initial public offering (the "Public Offering") of six million SCO shares at $12.50 per share, raising $75 million from public investors. App. A-2.

As admitted by Petitioners in the Prospectus, SCO was heavily dependent for its growth and prosperity

[1] References to the Petition for Writ of Certiorari and Petitioners' Appendix are denoted "Pet. ___" and "App. ___", respectively.

upon the Company's senior executives. App. A-3. As further represented in the Prospectus, the Company was headed by James W. Harris ("Harris"), the 49-year-old Chairman of the Board. *Id.*

The Prospectus detailed the numerous roles in SCO's affairs played by Harris. For example, Harris, who had become Chairman in January 1993, also had served as President and Chief Executive Officer of SCO and was on several Board committees. App. A-3 to A-5. Prior thereto, Harris had been employed by Microsoft Corporation and was involved in negotiating contracts between SCO and Microsoft. He also had been instrumental in resolving lawsuits for sexual harassment against the Company's former President and Chief Executive Officer, Petitioner Lawrence Michels. App. A-5.

In the Prospectus for the Public Offering, Petitioners repeatedly conveyed the misleading impression that Harris was actively involved in numerous senior-level positions at SCO. In its opinion, the California Court of Appeal summarized the numerous references in the Prospectus to Harris and his central roles at SCO as follows:

> *In a section entitled "Key Personnel," the prospectus . . . stated that the company's continued success would depend in part on its executive officers, the loss of any one of which "could adversely affect the Company's business."* None of the "key personnel" was identified by name; however, the reader was referred to a section entitled "Management."
>
> Under the heading "Management" were listed the "Executive Officers and Directors." *At the top of the list was James W. Harris, age 49,*

whose position with SCO was described as "Chairman of the Board." He was also listed as one of two members of the Compensation Committee . . . and one of two directors comprising the Audit Committee. He had been a director of SCO since March of 1988 and had also served for a brief time in December of 1992 and January of 1993 as SCO's President and Chief Executive Officer.

Several pages later, the prospectus stated that Harris was the only SCO director to receive cash compensation. He was paid $1,000 per day, plus expenses, for consulting services, including his services as Chairman of the Board, which services were provided on an as needed basis. . . .

In addition to this compensation, Harris had been granted various stock options, which were described in the prospectus. . . .

The prospectus described Harris's function as one of two directors on the Compensation Committee. The Compensation Committee made recommendations to the board concerning salaries and incentive compensation for SCO employees and consultants. *Harris was again referred to here as having been the President and Chief Executive Officer of the company from December 1992 to January 1993.*

In addition to his membership on the Compensation Committee and the Audit Committee, *Harris and Lars Turndal,* the current President and CEO of the company, *were the only two members of the Incentive Stock Committee,* which was responsible for administering SCO's 1984 Incentive Stock Option Plan. . . .

A section in the prospectus entitled "Certain Transactions" explained recent changes in upper

> *level management at SCO. In December of 1992, the company's President and CEO, Lawrence Michels, resigned pursuant to the settlement of a lawsuit against him and SCO alleging employment discrimination and sexual harassment. . . . The position of President and CEO was taken over by Harris until* Lars Turndal, then the Senior Vice President of the company, succeeded to that position in *January of 1993, at which time Harris became Chairman of the Board.*
>
> Also under the heading "Certain Transactions," the prospectus again described the consulting agreement between Harris and SCO.
>
> *The last mention of Harris in the prospectus appeared in a list of principal shareholders. He was listed as owning, prior to the offering, 55,000 shares, issuable upon the exercise of options* exercisable within 60 days after May 14, 1993.

App. A-3 to A-5 (emphasis added).

The Court of Appeal also properly accepted as true the factual allegations of the Complaint showing that defendants knew of Harris' terminal illness months before the consummation of the Public Offering:

> [A]t the time of the public offering defendants knew that Harris was terminally ill and they were aware that he had been forced to curtail his business activities on behalf of SCO because of that illness, from which he died less than two months later. It is further alleged that as early as January of 1993, when preliminary work for the public offering was underway, defendants became aware of Harris's terminal illness. Among other things, Harris's participation with the working group was affected when

> he began to cancel meetings with representatives of the underwriters. Harris's illness, and the adverse impact his death would have on the company, were discussed in written communications circulated in February 1993 among the members of the work ıg group for the public offering. Harris had been advised, prior to the public offering, to get his personal affairs in order. Defendants knew that Harris would be unable to play any meaningful role in the company or on its board of directors after the public offering.
>
> Plaintiffs alleged that the descriptions in the prospectus of Harris's various positions and functions at SCO represented him as a "key" individual at the company and conveyed the impression that he would have a continuing and important role with SCO. Plaintiffs alleged further that these representations about Harris in the prospectus were made materially false and misleading by defendants' failure to disclose the information that Harris was terminally ill, that he was curtailing his involvement in company matters and that he would likely not be able to continue serving in his numerous corporate capacities.

App. A-6 to A-7.

On July 10, 1993, Harris died, but his death was not announced until July 14, 1993. Following the announcement of Harris' death and SCO's July 15, 1993 announcement of disappointing earnings, the price of SCO's stock fell to below $5.00 per share – a loss of more than 60% in value in a matter of weeks. App. A-6.

On July 27, 1993, *The Wall Street Journal* reported that SCO and the underwriters had known about Harris' ill health and impending death prior to the Public Offering.

B. Procedural History

After the plunge in the price of SCO shares and the public admission that the defendants had been aware of Harris' terminal illness, Respondents, on behalf of a class of purchasers of SCO shares, filed suit in Santa Clara County Superior Court, alleging that defendants had violated the federal securities laws by failing to disclose that Harris was terminally ill.[2] On October 1, 1993, Respondents filed a Consolidated and Amended Complaint.[3] Defendants demurred and the California Superior Court sustained the demurrers with leave to amend.

On February 1, 1994, Respondents filed the existing Complaint, asserting causes of action under Sections 11, 12(2) and 15 of the Securities Act, 15 U.S.C. § 77k, 77l(2) and 77o. Issue has not been joined and there has been limited discovery from just the underwriter defendants.

In the Complaint, Respondents allege that Petitioners *knew* that Harris was terminally ill and was curtailing his

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[2] There have been no rulings or proceedings as to class certification.

[3] Contrary to Petitioners' suggestion (Pet. 7), all plaintiffs here did not commence suit in federal court. Rather, Mr. Ackerman initially sued in federal court while the other plaintiffs filed suit in the Superior Court of California, Santa Clara County. In the interest of economy and efficiency, Mr. Ackerman agreed to consolidate his claims with those of the state court plaintiffs.

business involvement with SCO, and that Petitioners had a duty to disclose Harris' terminal condition in the Prospectus, given the repeated references therein to Harris and his numerous high-level roles at SCO. App. A-3 to A-7. Petitioners again demurred, arguing that Sections 11 and 12(2) of the Securities Act, as well as applicable SEC regulations, did not require Petitioners to reveal the health condition of Harris absent a particularized statement in the Prospectus that Harris was in "good health." The California Superior Court sustained Petitioners' demurrers to the Complaint without leave to amend.

C. Proceedings In The California Appellate Courts

Respondents appealed from the California Superior Court's order sustaining the demurrers. The California Court of Appeal for the Sixth Appellate District reversed the Superior Court's order, holding that the SCO Prospectus contained "numerous affirmative statements about Harris" (App. A-21), which

> arguably conveyed the overall impression of a person whose health permitted a certain level of active participation in company affairs. Consequently, defendants had a duty to disclose information that Harris's declining health, due to a known diagnosed terminal illness, had forced him to begin the process of cutting back his involvement with company affairs. Otherwise investors would be left with a misleading impression.

App. A-22. The Court of Appeal sustained the Section 11 claim and remanded to the trial court for a determination as to the sufficiency of the other claims under Sections

11(a)(2), 12 and 15 of the Securities Act. Thereafter, Petitioners moved for a rehearing which resulted in a modified opinion dated December 4, 1995 (App. B). The December 4 opinion distinguished the principal case on which Petitioners relied and clarified the Court of Appeal's earlier decision upholding the Complaint. Petitioners then filed a petition for review in the Supreme Court of California, which petition was denied on February 14, 1996.

Petitioners now ask this Court to review the Court of Appeal's decision. Because nothing compels such review, and because the facts of the case are highly specific concerning Harris' health and Petitioners' knowledge thereof, the Petition should be denied.

REASONS FOR DENYING THE WRIT

The Petition should be denied for the following reasons: (1) the disposition by the California Court of Appeal of the federal securities law issues is in conformity with applicable federal securities statutes, regulations and decisions of this Court, including *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), and the Legislative intent as expressed in Sections 11 and 12(2) of the Securities Act; (2) there is no conflict between the federal securities laws and the Americans With Disabilities Act (the "ADA") raised by the facts of this case; (3) the California Court of Appeal's decision does not conflict with any rulings of a Court of Appeals in another state or circuit; (4) the California Court of Appeal's decision, which has been expressly designated as "Not for Publication" (App. A-1)

has no likely ramifications beyond this case; (5) the question is presented in the context of a motion addressed to the legal sufficiency of the claim, is based on an incomplete factual record, and does not involve an important issue of federal law; and (6) Petitioners are improperly seeking advisory opinions of this Court on broad policy issues and disability statutes which have no relevance to this case.

I. NOTHING MANDATES THIS COURT'S REVIEW

Petitioners present two arguments in seeking this Court's review of the California Court of Appeal's decision. First, Petitioners contend that the decision is contrary to existing federal law governing an offeror's disclosure obligations in connection with a public offering. Pet. 10. Second, Petitioners contend that the decision conflicts with Section 12112 of the ADA by requiring investigations and disclosures to be made about an officer's or director's health that are prohibited by the ADA. Pet. 11. Neither of these arguments has any merit.

The California Court of Appeal's decision is a narrow, fact-intensive ruling fully consistent with existing law. As that Court stated:

> Our holding is a narrow one: on the facts alleged [including Petitioners' actual knowledge of Mr. Harris's terminal illness and imminence of his death], plaintiffs have stated a duty to disclose information regarding the terminal illness of the chairman of the board of SCO as it affected his continued involvement with the company, notwithstanding the absence of any

> particular statement in the prospectus affirmatively representing his good health.

App. A-22. Upon rehearing, the Court of Appeal further stated:

> Responding briefly to the second point raised by defendants in their petition for rehearing, *we emphasize that this case turns on allegations that defendants, at the time of issuing the prospectus, possessed specific knowledge that the Chairman of the Board of Directors was gravely and terminally ill, such that his continued participation in the company could no longer be expected. We do not hold that the issuer has any general duty to disclose or inquire into the health of its officers and directors.*

App. A-28 (emphasis added).

As shown below, the California Court of Appeal's decision is consistent with well-established principles enunciated under the federal securities laws by this Court and many others. Similarly, the alleged "conflict" with the ADA is non-existent, was recognized to be a non-issue by the California courts and is only raised now by Petitioners to attract this Court's attention to an otherwise mundane dispute over the sufficiency of a pleading. Accordingly, review by this Court is unwarranted. There is no broad policy question raised by the facts of this case, and indeed, since the enactment of the federal securities laws more than 60 years ago, only a handful of authorities have even addressed the issue of whether an executive's health is a material fact warranting disclosure. Not surprisingly, those few cases have favored disclosure. *See* App. A-16 to A-20.

II. A. THE CALIFORNIA COURT OF APPEAL'S DECISION IS CONSISTENT WITH THE FEDERAL SECURITIES LAWS

Section 11 of the Securities Act imposes liability if a registration statement "contain[s] . . . an untrue statement of a material fact or omit[s] to state a material fact required to be stated therein or necessary to make the statements therein not misleading." 15 U.S.C. § 77k(a). Similarly, Section 12(2) imposes liability upon any person who "offers or sells a security by the use of . . . interstate commerce or of the mails, [or] by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading. . . . " 15 U.S.C. 77l(2).

The California Court of Appeal correctly held that Petitioners' "numerous affirmative statements" about Harris in the Prospectus arguably conveyed to investors a misleading impression about Harris' future participation in the Company. App. A-21 to A-22.

Petitioners protest that under Sections 11 and 12(2) liability for an omission attaches only where the omission renders a particular affirmative statement in a registration statement false, and that therefore no Section 11 and Section 12(2) liability could arise from the omission of Harris' terminal illness given the lack of an affirmative statement that Harris was in good health or that he would be continuing his activities with the Company for

any specific length of time. *See* Pet. 9. However, neither Section 11 nor Section 12(2) contain any such limitation.

Moreover, in their strained statutory analysis, Petitioners ignore the very words of Section 11, which imposes liability where a registration statement "omit[s] to state a material fact . . . necessary to make the statements therein not misleading," 15 U.S.C. § 77k(a). As the California Court of Appeal observed:

> The duty to disclose information under section 11 arises on the facts of each case. The essence of that duty is whether the statements made in the prospectus – and the statute itself refers to "statements" in the plural – are rendered misleading by the alleged omission.

App. A-21. Here, the omission of Harris' terminal illness rendered misleading the positive statements in the Prospectus which described Harris' important functions at SCO and implied that he would continue to actively engage in those roles.

Petitioners also mistakenly seek support for their position in the House Conference Report explaining Section 11:

> This phrase has been clarified in the substitute to make the omission relate to the statements made in order that these statements shall not be misleading, rather than making a mere omission (unless the act expressly requires such a fact to be stated) a ground for liability where no circumstances exist to make the omission in itself misleading.

Pet. 14, *quoting* H.R. Rep. No. 152, 73d Cong., 1st Sess. 26, at 277 (1933). There is no inconsistency between the Court

of Appeal's opinion and any legislative intent expressed by Congress. The Court of Appeal correctly determined that the omitted information regarding Harris' ill health *did* relate to the numerous express statements in the Prospectus concerning Harris' positions at SCO, and that his terminal illness soon would, and did, make it impossible for him to continue in those capacities, to SCO's detriment. App. A-21 to A-22.

Petitioners also argue that the California Court of Appeal violated this Court's "strict statutory construction approach" in applying the federal securities laws. Pet. 11, citing *Central Bank v. First Interstate Bank*, 114 S. Ct. 1439, 1444-48 (1994). As this Court has stated time and again, "any effort to construe a statute, including the securities laws, must begin with the language of the statute itself." *SEC v. Falstaff Brewing Corp.*, 629 F.2d 62, 68 (D.C. Cir. 1980), *cert. denied sub nom. Kalmanowitz v. SEC*, 449 U.S. 1012 (1980), *citing Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976) and *Lewis v. United States*, 445 U.S. 55 (1980).

As noted above, the Court of Appeal's opinion is entirely consistent with the language of Sections 11 and 12(2) of the Securities Act. Both statutes impose liability for the omission of material facts from offering materials necessary to make the statements therein not misleading. Respondents have alleged that facts regarding Harris' terminal illness were omitted from the Prospectus and that disclosure of such facts was necessary to make statements in the Prospectus regarding Harris not misleading. In upholding the Complaint, the Court of Appeal did no more than apply the plain words of the Securities Act.

The appellate court simply ruled that, accepting Respondents' factual allegations as true, Harris' terminal illness was an arguably material fact whose omission from the Prospectus rendered the numerous "statements therein" regarding Harris' roles at SCO misleading.[4]

B. TECHNICAL COMPLIANCE WITH THE SEC'S MINIMUM DISCLOSURE REQUIREMENTS DOES NOT INSULATE PETITIONERS FROM LIABILITY FOR THE DISSEMINATION OF A MISLEADING PROSPECTUS

Petitioners contend that SEC regulations, including SEC Regulation S-K, do not expressly require that the health of an executive, or his impending death be disclosed, and that therefore, the California Court of Appeal incorrectly held that the Petitioners had a duty to disclose that information. Pet. 16-19.

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[4] Petitioners' reliance on *In re Bank of Boston Corp. Sec. Litig.*, 762 F. Supp. 1525 (D. Mass. 1991) (Pet. 14-15) is misplaced. There, plaintiff-shareholders alleged not that the prospectus at issue was inaccurate at the time of its filing but that later developments made the prospectus inaccurate and should have been disclosed. The district court held that omissions which are only misleading in hindsight are not actionable under Section 11 or Section 12(2). *Id.* at 1538 (citation omitted).

Here, the Court of Appeal ruled that, given the facts alleged, the Prospectus' express statements about Harris created an impression of Harris that was misleading *at the time made*, not in light of later developments. The Court of Appeal's decision is thus consistent with federal law.

Petitioners are wrong as a matter of law. The SEC regulations upon which defendants rely, including Regulation S-K, establish only the *minimum* SEC disclosure requirements for a prospectus and registration statement. Thus, the fact that SEC regulations and statutes do not specifically state that a terminal illness must be disclosed is not dispositive as to whether that information must be disclosed to investors on an offering. Nor do SEC regulations detail all of the information that will be deemed material for disclosure purposes.

As the SEC expressly stated in one of its own interpretive releases:

> *The registration forms* promulgated by us are guides intended to assist registrants in discharging their statutory duty of full disclosure. They *are not and cannot be exhaustive enumerations of each and every item material to investors in the particular circumstances relevant to a specific offering*. . . . The preparation of a registration statement is not satisfied . . . by a mechanical process of responding narrowly to the specific items of the applicable registration form.

In re Franchard Corp., Securities Act Release No. 4710, [1964-1966 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶77,113 at 82,045 (July 31, 1964) (emphasis added).

Similar sentiments have been expressed by one leading commentator as follows:

> The SEC has published a number of forms which instruct issuers to place certain information in a registration statement. A rebuttable presumption that a registration statement is misleading should arise from failure to comply

> with those instructions; yet technical compliance with the form does not insure full disclosure. . . . Along the same lines, *facial compliance with the instructions for registration statements . . . does not* preclude a court from inquiring further into the accuracy of the assertions, or *insulate the defendant from a finding that the registration statement is misleading.*

— 5B Jacobs, *Litigation and Practice Under Rule 10b-5* § 61-01[c][i] (1991) (emphasis added).

Moreover, the applicable case law confirms that technical compliance with the SEC's regulations will not insulate a defendant from liability for a materially misleading prospectus. *See, e.g., Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 564-565 (E.D.N.Y. 1971) (compliance with Section 11 not guaranteed through technical compliance with registration forms); *see also Zell v. Inter-Capital Income Securities, Inc.*, 675 F.2d 1041, 1044 (9th Cir. 1982) (proxy schedule 14A sets forth minimum disclosure standards and compliance therewith does not guarantee compliance with Rule 14a-9); *Maldonado v. Flynn*, 597 F.2d 789, 796 n.9 (2d Cir. 1979) (same).

Thus, neither Regulation S-K nor the other regulatory provisions cited by Petitioners absolve them of liability under Sections 11 and 12(2) for issuing the materially misleading and incomplete Prospectus.

C. THE COURT OF APPEAL PROPERLY DETERMINED THAT HARRIS' TERMINAL ILLNESS COULD BE MATERIAL TO A REASONABLE INVESTOR

The well-established standard for materiality was reaffirmed by this Court in *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988), in which the Court, *quoting TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976), stated

> that to fulfill the materiality requirement "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."

This Court has also held that omitted facts or information can be material, even if they are not outcome-determinative. 426 U.S. at 449.

Here, the California Court of Appeal properly applied the *Basic* standard in determining that a reasonable investor might have viewed the omitted information about Harris' terminal illness as material to a decision to purchase SCO stock. *See Hines v. Data Line Systems, Inc.*, 53 Wash. App. 283, 766 P.2d 1109 (Wash. Ct. App. 1989) (importance of disclosures and omissions in private placement memorandum regarding health of CEO raised issue of material fact precluding summary judgment), *aff'd*, 114 Wash. 2d 127, 787 P.2d 8 (Wash. 1990); *Kas v. Financial General Bankshares, Inc.*, 105 F.R.D. 453 (D.D.C. 1984) (granting plaintiffs leave to amend complaint to allege that there were material misrepresentations or omissions in proxy statement concerning merger transaction where failing health of Company's director and

single largest stockholder was not disclosed); *In re Registration Statement of Cytotech Corp.*, SEC Release No. 33-6800, 1988 SEC LEXIS 1905 (September 29, 1988) (SEC halts public offering where registration statement fails to disclose that corporate consultant was suffering from leukemia).[5]

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[5] The California Court of Appeal correctly rejected petitioners' argument that *Cytotech* and *Data Line, supra* only apply to situations where affirmative statements are made about an executive's physical condition. The Court of Appeal reasoned as follows:

> Defendants argue that because the SCO prospectus included no affirmative statement regarding Harris's physical condition, similar to that contained in *Cytotech*, it was not misleading as a matter of law. We find this reasoning to be flawed, both logically and legally. It would lead to the conclusion in *Cytotech* that, absent Dr. King's statement, there would have been no duty to disclose adverse circumstances directly affecting the performance of the person solely responsible for the research and development of Cytotech's product. If this were the law, issuers of stock could conceal all manner of negative information, material to the company's future and avoid liability by simply not including a corresponding affirmative statement in the prospectus. Such a result defeats the protective purposes of the securities laws and we do not believe it could have been intended by the drafters of section 11. (*See, e.g., Ernst & Ernst v. Hochfelder, supra*, 425 U.S. at p. 200.)
>
> * * *
>
> Our remarks regarding *Cytotech* apply as well to *Data Line*. Even assuming there was an affirmative statement in the prospectus regarding Peterson's good health, we do not believe that such a statement

Similarly, the courts have held that disclosure is required where a company is dependent on a particular person, such as an officer or director, and the loss of services or other conduct of such person will adversely impact the company. *See e.g., Breard v. Sachnoff & Weaver, Ltd.*, 941 F.2d 142 (2d Cir. 1991); *SEC v. Electronics Warehouse, Inc.*, 689 F. Supp. 53, 66 (D. Conn. 1988), *aff'd*, 891 F.2d 457 (2d Cir. 1989), *cert. denied*, 110 S. Ct. 3228 (1990); *Gould v. Tricon, Inc.*, 272 F. Supp. 385, 390 (S.D.N.Y. 1967).[6]

> is a necessary predicate to a duty to disclose known facts regarding his failing health.

App. A-17, A-20 to A-21.

[6] Petitioners' reliance on *In re Numerex Corp. Sec. Litig.*, 913 F. Supp. 391 (E.D. Pa. 1996) and *In re Quarterdeck Office Sys., Inc. Sec. Litig.*, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶97,646 at 96,975 (C.D. Cal. Nov. 4, 1992) (Pet. 16) is totally misplaced. In *Numerex*, plaintiffs alleged that the chairman "must have known" at the time of a public offering of his plans to resign, which fact was not stated in the prospectus. The court held the resignation was not material because, among other reasons, the chairman in *Numerex* had been with the company for only about one year and there was no allegation that he brought any "valuable technical or business expertise" to the company. Here, in contrast, the Complaint specifically alleged defendants' knowledge of Harris' terminal illness and the key roles he played at SCO. *E.g.*, App. A-3 to A-7.

With respect to *Quarterdeck*, the Court of Appeal correctly distinguished that case, stating:

> Defendants' knowledge about one director's intention to sell his shares and resign from the board *at some point in the future* was clearly not the crux of the Section 11 cause of action . . . [M]oreover, it was *sheer speculation* whether or when Rosen would in fact decide that profits were such as to justify his selling and resigning from the Board.

App. B, A-27 (emphasis added).

Disclosure also has been mandated of facts concerning the quality and integrity of management and those controlling the company's affairs. *See Zell v. InterCapital*, 675 F.2d at 1045; *In re Franchard Corp.*, Securities Act Release No. 4710, [1964-1966 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶77,113 at 82,042 (July 31, 1964) ("Evaluation of the quality of management – to whatever extent it is possible – is an essential ingredient of an informed investment decision."); *In re Sweet's Steel Co.*, 4 S.E.C. 589, 1939 SEC LEXIS 547 (1939) (failure to disclose contemplated changes in issuer's management rendered registration statement misleading).[7]

Accordingly, the decision below is perfectly consistent with the rulings of this Court and others in analogous cases.

III. THE COURT OF APPEAL'S RULING DOES NOT CONFLICT WITH THE AMERICANS WITH DISABILITIES ACT

Petitioners argue that the California Court of Appeal's ruling requires a company to inquire into the health of issuers, officers and directors, in violation of the

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[7] *See also SEC v. Century Mortgage Co.*, 470 F. Supp. 300 (D. Utah 1978) (failure to disclose criminal charges against company's director and controlling person in amended prospectus was omission of material fact); *Kass v. Arden-Mayfair, Inc.*, 431 F. Supp. 1037 (C.D. Cal. 1977) (disclosure required where nominee may jeopardize corporate asset); *In re Laser Nucleonics, Inc.*, 44 S.E.C. 206, 207-208, 1970 SEC LEXIS 672 (1970) (failure to disclose accurate and sufficient information regarding the background and expertise of Company president).

ADA, 42 U.S.C. § 12101 *et seq.* *See* Pet. 19-25. Because, as explained above, Respondents allege that Petitioners already knew of Harris' terminal illness, not that they should have investigated his health and would have discovered his condition, the ADA "issue" is a non-issue.

Contrary to Petitioners' suggestion, there is nothing in the ADA – either in the express language of the statute, or the legislative history thereof – which expressly prohibits the disclosure of information concerning the terminal illness of an executive where, as here, that information would be material to a reasonable investor. Moreover, the facts of this case present no conflict between the disclosure obligations under the federal securities laws and any privacy expectations allegedly existing under the ADA. Finally, Petitioners have cited no cases – indeed none exist – which support their position that the disclosure provisions of the securities laws conflict with the ADA.

The ADA recognizes that the identification of an individual's disability can lead to discriminatory treatment by an employer; however, Harris was not being discriminated against by SCO on the basis of his illness – the Prospectus made clear he was continuing to receive substantial compensation and other benefits. Moreover, as Harris was already known to have a terminal illness, there was no issue of SCO's requiring him to have a medical examination or inquiring into the nature and severity of his illness. Thus, the ADA's protections are not at issue.

Petitioners simply refuse to accept that any set of circumstances could create a duty to disclose an officer's

or director's illness in a prospectus which contains no affirmative statements expressly referring to that person's health. According to Petitioners' thinking, then, even if all of an issuer's directors and officers were terminally ill; even if they had all recently revised their wills; even if they had all recently made funeral and burial arrangements; even if they had all made reservations to check into hospices the day after the offering; even if doctors had predicted that none of them would live longer than a week after the offering – so long as the prospectus says nothing about management's health, nothing need be disclosed in the prospectus regarding the terminal illness and imminent deaths of the issuer's management. No such absurd result should be permitted under the federal securities laws, which were enacted to protect and inform investors. *See, e.g., Basic Inc. v. Levinson*, 485 U.S. 224, 234 (1988) ("We have recognized time and again, a 'fundamental purpose' of the various Securities Acts, 'was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*. . . . ' " (Citations omitted.)).

Petitioners also mistakenly rely on various media articles and one law review article on the ADA to support their argument that a key executive's terminal illness need not be disclosed. Pet. 18 n.5; and 19 n.7. However, the sources upon which they rely suggest that the corporate trend is in fact towards more timely and candid disclosure of executive illnesses in SEC filings, not non-disclosure.

These articles also refer to many examples where companies, unlike SCO, have disclosed serious health problems of their key personnel, *e.g.*, Michael Eisner of Disney; John Welch of General Electric; Michael Walsh of

Tenneco; Steve Ross of Time-Warner; and Dominick C. Fanello, CEO of Shiloh Industries. The articles also recognize that news about an executive's health may constitute a material fact that significantly affects a company. *See, e.g.*, Susan Antilla, *Death and The Company; Should Shareholders Know The State of CEO's Health?* International Herald Tribune, June 27, 1994; Rob Seitz, *Corporate Conundrum: Disclosing Illness in the Corner Office*, N.Y. Times, May 2, 1993; *see also* Andrew K. Glenn, *Disclosure of Executive Illnesses Under Federal Securities Law and the Americans With Disabilities Act of 1990: Hobson's Choice or Business Necessity?*, 16 Cardozo L. Rev. 537, at 537, 540 and 559 (1994) ("When an executive's personal dealings affect the issuer's business or at least present a strong potential for doing so, the materiality threshold may be reached and therefore disclosure will probably be necessary. . . . Of course, if an issuer chooses not to disclose an executive's illness and it is material information, the issuer may be liable for nondisclosure. . . . Applying the *Basic* formula, three factors will be dispositive in determining whether an executive's illness is material: (1) the executive or significant employee's relative importance to the corporation; (2) the severity of the illness; and (3) the probability, at the time the corporation learns of the illness or the time of diagnosis, that the illness will force the executive to leave his position.")

Finally, Petitioners assert that the Court of Appeal's decision leaves companies with a "Hobson's choice": allow officers and directors to keep their health private and risk a securities lawsuit should one of them become ill and die, or violate the ADA by investigating the health of the key executives mentioned in a prospectus. *See* Pet.

24.[8] Petitioners also speculate that disclosure of health problems will "chill[]" the willingness of persons to serve as officers and directors. *Id.* 25.

Notably, Petitioners conveniently overlook a third option that could have been exercised: forego raising $75 million from unsuspecting public investors until after Harris' terminal illness had become a matter of public knowledge. This "abstain or disclose" principle is well established under the federal securities laws. *See, e.g., SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (*en banc*), *cert. denied*, 394 U.S. 976 (1969); *Shaw v. Digital Equip. Corp.*, 1996 U.S. App. LEXIS 10461 (1st Cir. May 7, 1996) (corporate issuer in possession of material adverse information must disclose that information or abstain from proceeding with public offering).

Petitioners' speculation about the future development of the law regarding health-related disclosures (Pet.

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[8] Petitioners adopt the term "Hobson's Choice" from the *Cardozo Law Review* article they cite. However, even that article suggests that, contrary to what Petitioners assert in footnote 15 of the Petition, the concept of disclosure of an executive's illness under the federal securities laws is consistent with, and not contrary to the EEOC regulations promulgated pursuant to the ADA, and in particular with 29 C.F.R. 1630.15(e) (1994), which provides that if an "alleged discriminatory action was taken in compliance with another Federal law or regulation [*i.e.*, the securities laws], the employer may offer its obligation to comply with the conflicting standard as a defense." *See* 16 Cardozo L. Rev. 537 at 581-582 (1994). The commentator also suggests that "[w]hen an issuer is threatened with liability under the Securities and Exchange Acts, it is doubtful that a conscientious executive would withhold disclosure of an illness." *Id.* at 587, n.266.

24-25) certainly does not justify this Court's review for several reasons. First, the decision below is "Not for Publication." App. A-1. Additionally, the decision below is a limited one. The California Court of Appeal ruled only that given the facts alleged, including Petitioners' actual knowledge of Harris' terminal illness, Respondents had stated a Section 11 claim against defendants. The Court of Appeal specifically stated

> [w]e do not hold that the issuer has any general duty to disclose or inquire into the health of its officers and directors.

App. B, A-28 n.4.

Accordingly, the Court of Appeal's decision in this *sui generis* case is consistent with the applicable statutes and regulations governing the federal securities laws, with this Court's rulings thereunder, and with the ADA.

CONCLUSION

This case does not present special or important reasons for review. Instead, it involves a narrow unpublished opinion that is fully consistent with other decisional and statutory law, and arises out of very specific and unusual facts. For all of the reasons stated above, the Petition should be denied.

Respectfully submitted,

LOWEY DANNENBERG BEMPORAD
& SELINGER, P.C.
RICHARD B. DANNENBERG
Counsel of Record
RICHARD BEMPORAD
JODY KRISILOFF
747 Third Avenue
New York, NY 10017
(212) 759-1504

Attorneys for Respondents

Of Counsel:
LIEFF, CABRASER, HEIMANN & BERNSTEIN
JAMES M. FINBERG
Embarcadero Center West
275 Battery Street, 30th Fl.
San Francisco, CA 94111
(415) 956-1000

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